SUPREME COURT, U. S.

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IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1971**

**No. 71-319**

EDWARD C. JOHNSON 2d, EDWARD C. JOHNSON 3d, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION,

*Petitioners,*

v.

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.,

*Respondents.*

## BRIEF OF RESPONDENT ROSE MOSES IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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## BRIEF OF RESPONDENT ROSE MOSES IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

The petition for certiorari invites this Court to undertake an excursion into legal history. It asks the Court to declare unlawful the recapture of "give-ups"; but give-ups have been abolished since December 1968 (Fdg. 35, A. 13; B. 21).* It also asks the Court to review the standards of "gross misconduct" under former § 36 of the Investment Company Act; but the 1970 amendment of § 36 (G. 39) has

* Abbreviated references are used herein as follows:
"R." refers to the record appendix below; "Fdg." to the findings of the District Court; "Ex." to the separately bound exhibits; "A." to "E." to the Appendices, so designated, of the petition; "F." "G." and "H." to the Appendices, so designated, of this brief.

eliminated the concept of "gross misconduct" from the statute. A determination of the issues presented by the petition could thus have no significant impact on existing law or on future controversies.

The supposed conflict of the decision below with a decision of the Second Circuit (Pet. 27) will be seen to be imaginary. Petitioners' request for a review of the facts of the case (Pet. 28-30) would call for an examination and evaluation of a complex record of more than 5000 pages. The various rulings of the Court of Appeals attacked by the petition will be shown to be correct in all respects.

## Opinions Below

The opinion of the Court of Appeals is reported at 445 F. 2d 369, that of the District Court at 316 F. Supp. 31.

## Statutes and Regulations Involved

In addition to the statutes and regulations referred to in the petition (p. 3), we annex hereto pertinent parts of the text of §§ 1(b), 2(a) and 10 of the Investment Company Act, as effective during the period involved in this litigation (Appendix F.); § 36 of the same Act as amended in 1970, 84 Stat. 1428 (Appendix G.); and certain stock exchange rules (Appendix H.).

## Statement of the Case

### A. Jurisdiction and proceedings.

In this stockholder's derivative action commenced on December 5, 1967 (R. 2), the District Court's jurisdiction, based on the Investment Company Act of 1940 (the "Act"),

15 USC §§ 80a-1 et seq., was sustained by both Courts below (A. 44; B. 57) and is not questioned here. After a non-jury trial limited to the issue of liability (B. 2), the District Court for Massachusetts (Wyzanski, C.J.) dismissed the action (A. 1, 60). The First Circuit (per Aldrich, Ch. J.) unanimously reversed to the extent of sustaining petitioners' liability with respect to so-called "NASD recapture"; and it remanded the case for a determination of damages (B.1, 31, 32). That determination has not yet been made.

**B. The parties.**

Respondent Moses is a stockholder of defendant Fidelity Fund, Inc. (the "Fund"), a mutual fund registered under the Act; she brought this action on behalf of the Fund. The real defendants were the directors of the Fund, including petitioners Johnson 2d and his son, Johnson 3d*; the Fund's investment adviser, petitioner Fidelity Management and Research Company ("FMR"); and the Fund's principal underwriter, petitioner Crosby Corporation ("Crosby"), a wholly owned subsidiary of FMR (Fdgs. 1-7, A. 3-4). FMR and Crosby are sometimes herein collectively called the "Management Company".

FMR managed the affairs of the Fund pursuant to a contract under which the Fund paid it annual advisory fees equal to 0.5% of the Fund's net assets up to $200 million and 0.35% of all additional assets. As of mid-1968, the net assets of the Fund were over $834 million (Fdgs. 2, 3, A. 3-4).

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* The action has been dismissed as to the other appearing directors.

Crosby distributed the shares of the Fund to the public, on a continuous basis, through a country-wide dealer organization. Pursuant to the underwriting contract, the Fund sold its shares to Crosby at their current net asset value. The ultimate purchasers paid an additional sales charge or load of 7½% (subject to volume discounts), of which the dealer received 6% and Crosby 1½%.

The charter of the Fund (R. 5452) forbade it to issue or sell its shares at a price which, after underwriting discounts or commissions, would yield it less than the net asset value of the shares.* This provision, critical to the decision below (B. 7-8), is ignored by petitioners.

### C. The divided allegiance of the Fund's fiduciaries.

The Fund had no officers or employees devoted solely to its interests. All of them were also stockholders, officers, directors or employees of the Management Company. Their compensation was paid by the Management Company; the Fund paid them nothing (R. 4077-78, 4244).

Petitioner Johnson 2d was the president and board chairman of the Fund; he was also the president, board chairman and principal voting stockholder of FMR. Petitioner Johnson 3d was at all relevant times a vice-president and, since April 1968, a director of the Fund; he was also a vice-president, director and substantial voting stockholder of FMR. Between them, the Johnsons owned 90% of the voting stock of FMR (R. 4076-77, 4243-44).

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* Paragraph 1 of the charter (R. 5452) provided that—
"in no event shall any shares of Capital Stock of the corporation be issued or sold for a consideration (which shall be net to the corporation after underwriting discounts or commissions) less in amount or value than the net asset value of the shares so issued or sold, * * *."

George Sullivan was the executive vice-president of the Fund. He was also a vice-president and stockholder of FMR as well as the president and a director of Crosby (R. 4076-77).

The firm of Gaston, Snow, Motley & Holt ("Gaston Snow") were counsel for the Fund (R. 4257). Simultaneously they were also counsel for the Management Company (R. 2112). Mr. Caleb Loring, Jr., a member of the firm, was a vice-president and the clerk (secretary) of the Fund; he was also a director, vice-president, secretary and stockholder of FMR (R. 4077).

Thus all officers and employees of the Fund as well as its counsel were under dual allegiance to the Management Company.

In these circumstances, the Fund's protection against managerial overreaching depended on those of its directors who were not affiliated with the Management Company. As required by §§ 10(a) and 10(b)(2) of the Act (F. 37-38), a majority of the Fund directors were unaffiliated. Petitioners, however, intentionally withheld from the unaffiliated directors vital information necessary for the discharge of their functions; petitioners thereby enabled themselves to profit at the expense of the Fund. It is this conduct of petitioners which is the major basis of the decision below (B. 28-29).

**D. Petitioners' give-up practices.**

The Management Company's compensation from the Fund depended, in large measure, on the number of Fund shares sold to the public. Increased stock sales swelled Crosby's sales charges; they also enhanced the size of the

Fund and, with it, the advisory fees of FMR. Petitioners thus had a vital interest in stimulating the sales of the Fund's shares.

The volume of these sales depended on the efforts of the dealers whom Crosby used to sell the shares. It was Crosby's responsibility to pay the dealers. Their contractual compensation was a portion of Crosby's sales charge. Crosby seized upon a method to provide extra rewards for the dealers, but not from its own resources. It used the Fund's portfolio brokerage business, and the commissions generated thereby, to discharge its own responsibility.

The means were basically simple. The Fund bought and sold great amounts of portfolio securities on the New York and regional stock exchanges ("portfolio transactions"). The Fund's brokerage commissions added up to large sums —more than $6 million in 1967 (R. 4248). So attractive was the Fund's portfolio business to the executing brokers that they were willing to surrender a substantial part of their commissions. Direct commission rebates to the Fund were forbidden by the minimum commission and anti-rebate rules of the constitutions of the several exchanges (B. 3; see D. 1 et seq.). The exchange rules, however, permitted executing brokers to "give up", i.e., to pay parts of their commission to other brokers or dealers designated by the customer. These "customer-directed give-ups" (herein called "give-ups") could be directed to brokers or dealers who had no part whatever in the portfolio transactions which gave rise to the commission.

At the behest of the Management Company, the Fund directed give-ups to those dealers who sold the shares of the Fund to the public (B. 3-4). More than one-third of the

Fund's brokerage commissions ($2,116,498 in 1967) was used in this fashion (R. 4421). As a result, the dealers' contractual compensation (6% of the offering price of the shares) was augmented to 7%, 8% or more (R. 1996-97). Crosby was relieved of any need to pay this extra dealer compensation from its own resources.

The SEC had long been critical of give-ups which did not inure to the benefit of the funds and their shareholders (pp. 9-10, below). In response to SEC pressure, the exchanges finally issued a flat prohibition of all customer-directed give-ups effective December 5, 1968 (Fdg. 35, A.13; B. 21; R. 3755). See *Independent Broker-Dealers' Trade Ass'n* v. *SEC*, 442 F. 2d 132 (D.C. Cir. 1971), *cert. den.* U.S. (No. 70-232, Oct. 12, 1971).

**E. The possibility of recapturing give-ups for the Fund.**

The give-ups, generated by the Fund's commission payments but used by petitioners for their own benefit, could instead have been channeled back to the Fund. As will be seen, such "recapture" by the Fund could have been effected lawfully and in complete harmony with all applicable stock exchange rules. The SEC repeatedly and emphatically supported recapture. Rulings of the very stock exchanges concerned with recapture sanctioned it. The uncontradicted testimony of two witnesses expert in stock exchange practices, including the expert called by petitioners themselves, vouched for the propriety of recapture. The Court below sustained it. Petitioners alone dissent, but their views simply reflect their self-interest; for by denying recapture to the Fund they enabled themselves to use the give-ups to their own advantage.

**1. *Recapture through Pacific Exchange membership.***

In early 1965, subsidiaries of the management companies of four large mutual fund complexes secured membership on the Pacific Coast Stock Exchange ("Pacific Exchange"). These subsidiaries executed the portfolio transactions of the funds at the prevailing commission rates or received give-ups from the brokers who executed the transactions. The management companies, in turn, applied all or part of their subsidiaries' brokerage profits from commissions and give-ups to reduce the advisory fees payable by the funds. The funds thus recaptured part of their brokerage expenses through the reduction of their advisory fees. (See pp. 109-10, 172-73 of the SEC Report identified at p. 9, below.)

This recapture method, based on the acquisition of exchange membership by a management company affiliate, will be called "exchange recapture".

**2. *NASD recapture; the SEC hearings of 1965 and 1966.***

Exchange recapture was not the only available recapture method. Several regional exchanges, including the Philadelphia-Baltimore-Washington Stock Exchange ("PBW Exchange"), permitted their members to pay give-ups to non-exchange members, provided that the recipients were members of the National Association of Securities Dealers ("NASD") (D. 3-5). Similarly, the Pacific Exchange permitted give-ups to NASD members who became "preferred rate" or "approved non-members" of Pacific; that status was available to all NASD members upon payment of a nominal fee (D. 9-10, 13-14).

Petitioner Crosby was a member of NASD (R. 4075). Accordingly, PBW and Pacific Exchange give-ups generated by the Fund's portfolio commission business could

have been directed to Crosby, followed by a corresponding reduction of the advisory fees payable by the Fund to FMR. This recapture method is herein called "NASD recapture".

On June 3, 1965, the staff of the SEC conducted a hearing (Fdg. 65, A. 23) attended by officers of the Management Company and a law partner of Gaston Snow, Mr. Loring's firm. The SEC officials "suggested that Crosby, though not an exchange member, could receive give-ups through its NASD membership, which could then be set off against the advisory fee" (B. 14). The Management representatives raised various objections, but did not suggest that NASD recapture might be contrary to the exchange anti-rebate rules (B. 14-16).

A year later, on September 23, 1966, the SEC staff conducted another hearing (Fdg. 67, A. 24) attended by the same Management representatives. The SEC officials again suggested, indeed urged, that the Fund should recapture through Crosby (B. 15-16; R. 2209-18). The Management representatives admitted, upon question, that nothing had been done about recapture since the previous hearing (B. 16). Again they did not suggest the supposed illegality of recapture under the anti-rebate rules (*ibid.*).

### 3. *The SEC's Public Policy Report.*

About two months after this hearing, on December 2, 1966, the SEC issued its *Report on the Public Policy Implications of Investment Company Growth*, 89th Cong., 2d Sess., H.R. 2337 (Ex. 6, herein called "PPI"). The SEC criticized the use of give-ups for the benefit of adviser-underwriters rather than the fund shareholders (PPI 172):

> "Although the commissions are generated by fund portfolio transactions and are paid by the funds,

> their use as extra compensation for sales of fund shares benefits the adviser-underwriters and the retail sellers of fund shares rather than fund shareholders."

The SEC then referred to the exchange recapture effected by the four mutual fund complexes on the Pacific Exchange (PPI 109-10, 172-73) and suggested widespread emulation in the interest of affording greater protection to fund shareholders (PPI 173):

> "Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions."

The SEC further stated that its views similarly applied to NASD recapture (PPI 173):

> "It would not be inconsistent with those [regional exchange] rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds."

The SEC was thus clearly aware of the "existing commission rate structure" (PPI 173), including minimum commission and anti-rebate rules, but made it plain that it found no conflict between those rules and any type of recapture.

**4. *The recapture ruling of the PBW Exchange.***

The correctness of the SEC's interpretation of the regional exchange rules was confirmed by a ruling of the PBW Exchange of December 14, 1967, which expressly sanctioned NASD recapture by a mutual fund. The fund (called Pro Fund, Inc.) was permitted to direct a PBW member (Cannon) to give up 40% of its fund-generated commissions to the fund's NASD adviser-underwriter; the latter would credit the give-ups against the advisory fees of the fund (Fdg. 71, A. 24-25; B 21; see R. 1927).

Mr. Wetherill, the president of PBW, later testified that *any* NASD adviser-underwriter was free to accept give-ups of this kind and to apply them against the advisory fees of mutual funds under its management (R. 1876-77, 1887). He further made it plain that the ruling in the Pro Fund case was no innovation, but reflected what had always been the policy of the PBW Exchange (R. 1881-82, 1887).

**5. *The Reilly report.***

Following the commencement of this action in December 1967 and a further SEC release pressing for recapture (R. 3740),* the Gaston Snow firm, counsel for the Fund and the Management Company, undertook an investigation of all recapture possibilities on the regional exchanges. Mr. Reilly, an associate of the firm, visited the regional exchanges and conferred with their leading executives (R. 2508-09). His detailed report of March 25, 1968 (R. 3976) concluded that recapture appeared possible on every major regional exchange (R. 4005):

> "From the above outline it seems that on each of the leading regional exchanges it is possible, through

* Release No. 8239 of January 26, 1968 (R. 3740).

techniques varying from direct to indirect, for a mutual fund to either execute a transaction at less cost or to receive credit against expenses for a portion of commissions paid."

**6. *The recapture ruling of the Pacific Exchange.***

Petitioners did not accept Reilly's findings but, after waiting two months, asked the Pacific Exchange for "definitive answers" whether NASD recapture was indeed permissible despite the anti-rebate rules (R. 4040, 4052-53). On July 25, 1968, after thorough deliberation (R. 4059), the Exchange's president, Mr. Phelan, confirmed the advice previously given to Mr. Reilly (R. 4061-62): In the case of the four fund complexes, the anti-rebate rule had been interpreted as not precluding exchange recapture. The same interpretation, Mr. Phelan ruled, was applicable to NASD recapture (R. 4061-62):

> "We have interpreted this provision [of the Pacific Exchange's anti-rebate rule] as not precluding any of our members receiving 'give-ups' from adjusting the management fees for funds they manage to a degree proportionate to the amount of the 'give-ups' received, and the same interpretation would be applicable to preferred rate firms."
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> • • •
>
> "The Exchange does not purport to exercise any control over the management fee charged by [FMR] or the adjustment of fees by virtue of its increased earnings from 'give-ups' received by [Crosby], its wholly-owned subsidiary."

Crosby thereupon became a preferred rate or approved non-member of the Pacific Exchange (R. 840).

**7. *The Fund's tardy recapture.***

Despite the SEC's repeated warnings in 1965 and 1966, petitioners took no *ante litem* steps to effect recapture or even to test its possibility. Even after the commencement of this action on December 5, 1967, petitioners waited nearly a year before recapturing any PBW or Pacific give-ups for the Fund. In May and July 1968 FMR instructed its PBW and Pacific brokers to "bank" their give-ups, that is, to hold them until further direction (Fdgs. 78, 79, A. 27). Finally, on November 27, 1968, counsel advised the unaffiliated directors of the Fund that they must decide in their best judgment whether or not to recapture the "banked" give-ups (R. 4529). The directors thereupon voted to recapture them (R. 4526-28), and the banked give-ups were in fact recaptured by the Fund (R. 823, 842).

**8. *The expert testimony.***

The common feature of exchange recapture and NASD recapture was that a fund's portfolio commissions, or the give-ups generated thereby, were applied in reduction of the advisory fees of the fund. The uncontradicted expert testimony demonstrates that such a fee reduction was not in conflict with the exchange anti-rebate rules.

Mr. Robert M. Bishop, vice-president of the New York Stock Exchange ("NYSE") in charge of the enforcement of its minimum commission rates (R. 4289-91), testified (R. 4387-88):

> "Q. Now, let's assume that a member firm is an investment adviser on an open end investment company and intends to execute orders for that open end investment company.

"A. Do you mean it has the investment management contract?

"Q. Correct. Can it reduce its advisory fee in an amount which is equivalent to the commissions that it receives for executing the Fund orders?

"A. Yes.

"Q. That is not a rebate?

"A. No."

Faced with this testimony, petitioners took the deposition of Mr. Donald Calvin, another vice-president of the NYSE and member of the bar, whose duties included all Exchange dealings with the SEC (R. 5019-20, 5024). Mr. Calvin testified (R. 5107):

"Q. And it would be permissible, would it not, for a member acting as an investment adviser, or member organization acting as an investment adviser, to a Mutual Fund to provide that its advisory fee be reduced in accordance with commissions received on portfolio transactions of the Fund, is that right?"

"A. My understanding is that that is correct."

The witnesses thus agreed that an adviser-underwriter, upon receiving the fund's portfolio commissions (or commission give-ups), is free to allow a corresponding reduction of the fund's advisory fees. Such a fee reduction is not a forbidden rebate and is, therefore, a lawful and proper vehicle for recapture of commissions or commission give-ups by the fund.

The testimony, to be sure, related to the anti-rebate rule of the NYSE; but since that rule is the "prototype" of the corresponding regional exchange rules (A. 51; Pet. 5, n. 6), the expert testimony of Mr. Bishop and Mr. Calvin powerfully supports the rulings of the PBW and Pacific Exchange officials sanctioning the NASD recapture of fund-generated commission give-ups through credits against the fund's advisory fees.

**F. Petitioners' misconduct: concealment of available recapture possibilities from the Fund's unaffiliated directors.**

***1. Petitioners' supression of recapture information.***

Petititoners have been found grossly derelict in failing to inform the Fund's unaffiliated directors of the SEC's repeatedly expressed views in favor of NASD recapture (B. 28). It is now undisputed that, under the charter of the Fund (p. 4, above), the recapture of give-ups, if practicable, was mandatory (B. 7-8). Petitioners' self-interest, however, was intensely opposed to recapture; every give-up dollar recaptured by the Fund became unavailable to stimulate the fund-selling dealers and, hence, could not boost petitioners' compensation. Only the unaffiliated directors, under the guidance of independent counsel, could have formed an unbiased judgment on the practicability of recapture.

Petitioners prevented the unaffiliated directors from exercising that judgment and from seeking the recapture mandated by the Fund's charter. The Court below found, and it is undisputed, that petitioners were familiar with the SEC's repeated recapture suggestions (B. 27-28). Equally undisputed here is the finding below that petitioners withheld this information from the unaffiliated directors (B. 14-22, 27-28). Even after the institution of this action forcibly brought recapture to the attention of the directors did petitioners persist in their policy of secretiveness. Reilly's finding that NASD recapture was readily available on both the PBW and Pacific Exchanges (R. 3984, 3999) was kept by petitioners from the unaffiliated directors, on the transparent plea that "they might not see the forest for the trees" (B. 20-21; R. 883-84, 955-58, 1080).

Johnson 2d, Loring and Sullivan compounded the suppression of Reilly's findings by downright misrepresentations. At the Fund's board meeting of March 28, 1968, Sullivan, in the presence of Johnson and Loring, told the directors that counsel (i.e., Mr. Reilly), having visited all the major regional exchanges, "had concluded that the anti-rebate rules of all these regional exchanges appeared to prevent any recapture by the Fund" (see the board minutes of May 29, 1968, R. 3397-98, summarizing the board proceedings of March 28, 1968). In fact, Reilly had reached the opposite conclusion, that recapture seemed possible on each of the leading regional exchanges (R. 4005).*

**2. *Petitioners' alleged reliance on counsel.***

Petitioners' claimed excuse that they acted in good faith and on the advice of counsel has not been sustained by either Court below. It flies against the overwhelming weight of the evidence.

None of petitioners claims to have consulted counsel after the first SEC hearing of June 1965. After the second hearing of September 1966, Johnson 2d talked to Loring; but Loring, as the owner of 18,500 FMR shares (R. 884) and as dual officer and counsel of the Fund and FMR, was not the man to give unprejudiced legal advice on matters involving a conflict of interests between FMR and the Fund. Even so, Loring told Johnson 2d no more than that NASD recapture "would pose a problem because of the anti-rebate

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* Petitioners have attempted to dispute the accuracy of the quoted May 29 minutes, but Mr. McKenzie, one of the unaffiliated directors, confirmed it (R. 1537-38). The May 29 minutes were signed by Loring (R. 3402), and they were approved by all the directors, including Johnson and Sullivan, at the next board meeting of June 27, 1968 (R. 3403).

rules" (R. 718) and that he thought it "improbable" that recapture could be effected by these methods (R. 719). Johnson 2d was clearly aware that he was not getting a legal opinion which might exculpate him.* Neither petitioners nor their counsel bothered, prior to this action, to inquire from any of the regional exchanges whether NASD recapture, as urged by the SEC, was feasible (R. 906). Upon these facts, petitioners' claim that "counsel investigated the available materials relevant to any NASD recapture" (Pet. 28) is patently unfounded; the Court of Appeals was right in holding (B. 16):

> "'Investigation' seems a palpable exaggeration of what was done. All the record shows is that they [the Management defendants] discussed it among themselves."

There is even less substance to petitioners' alleged reliance upon statements made by Mr. Loomis and Mr. Phillips, General Counsel and Assistant General Counsel of the SEC, at the Mutual Funds Conference held at the University of Pennsylvania Law School in February 1967 (Pet. 11; Ex. 1-K, Attachment, 115 U.Pa.L. Rev. 835, 853). The state-

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* Johnson 2d testified (R. 176-77):

> "The Court. • • • we are all aware that sometimes clients seek, and for good reason and perfectly honorably, to have the protection of a lawyer's opinion. • • • Ordinarily somebody who wishes to take advantage of that kind of exculpatory provision in the statute or an exculpatory provision implied in the common law or the law of trusts would put a formal question and get a formal answer from his detached, informal (sic) lawyer. As I understand it, you did not try to take advantage of any such exculpatory mechanism but you, on the contrary, made what could be called a rather informal inquiry and got a rather informal answer.
>
> "The Witness. I think that is fair."

ments, read in context, merely suggested that, so long as the stock exchange rules permitted give-ups, funds could be expected to "do something with these commissions" rather than wasting them. Neither Mr. Loomis nor Mr. Phillips so much as hinted that recapture was impossible or illegal; and it is preposterous to suggest that SEC counsel meant to contradict the recapture views expressed by the SEC itself only two months before in its PPI Report.

Most important, petitioners themselves do not claim that they were advised by counsel to keep the recapture information from the unaffiliated directors. Petitioners knew that the government agency charged by Congress with the administration of the Securities Exchange Act and the Investment Company Act favored recapture and deemed it consistent with the rules of the stock exchanges. Whatever contrary legal advice petitioners might have received, they were thus "on full notice that the possibility of recapture was a substantial issue that directly involved their self-interest" (B. 27). In these circumstances, it was sheer arrogance for petitioners to take the resolution of the issue into their hands and to resolve it in favor of their own aggrandizement, to the exclusion of the unaffiliated directors, who were by law appointed as the "watch-dog directors" of the Fund (B. 13). It was petitioners' failure to disclose the possibility of any NASD recapture to the unaffiliated directors which the Court below branded as "gross misconduct" (B. 28). Petitioners can and do point to no evidence that counsel ever encouraged their blatant disregard of the unaffiliated directors.

## *REASONS FOR DENYING THE WRIT*

## POINT I

### The Court of Appeals properly sustained the legality of NASD recapture.

Petitioners contend that NASD recapture violated the minimum commission and anti-rebate rules* of the PBW and Pacific Exchanges. It also violated, they say, the anti-trust laws. Neither contention has merit.

#### A. Recapture did not violate the anti-rebate rules.

The Court below sustained NASD recapture. The SEC urged it. The PBW and Pacific Exchanges sanctioned it. The expert witnesses vouched for it. Only petitioners contend, but without even an attempt at analysis, that the "scheme" was "patently" a forbidden rebate (Pet. 7, 18-22).

1. Petitioners' fundamental error is their conception of the anti-rebate rules as providing "that every customer would pay identical commissions" (Pet. 21). Petitioners misread the rules. The prescribed commission rates were and are *minimum* commissions.** Brokers could charge more, and they often did. Customers' charges were thus by no means uniform.

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* For brevity, we shall sometimes refer to these rules collectively as "anti-rebate rules".

** See PBW Const. Art. XX, § 1 (D. 2-3):

> "* * * commissions shall be at rates *not less than* the rates in this article prescribed; and they shall be absolutely net and free from any rebate, * * *". (Emphasis added.)

To the same effect are NYSE Const. Art XV, § 1 (D. 1), and Pacific Const. Art. XIV, § 1 (D. 7-8).

Differential charges frequently arose in connection with a broker's investment advice to his customers. Brokers were not required to make an extra charge for their investment advice; the minimum commission included compensation for the advice.* But since the commissions were *minimum* commissions, brokers were free if they chose (and if the customers agreed) to charge an advisory fee in addition to the commission. So long as the brokers received the minimum commission, nothing in the anti-rebate rules either required or forbade an additional advisory fee.

Since it was a matter of indifference under the exchange rules whether the extra advisory fee was large or small or zero, the broker was also free to reduce the fee in proportion to the volume of the customer's commission business. In other words, he could reduce the fee by the amount of the commissions. This was frequent practice; see the SEC's PPI Report (Exh. 6, pp. 108-9):

> "The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for non-fund clients."

Nothing in this practice contravened the anti-rebate rules; for despite the reduction or even the elimination of the advisory fee, the customer still paid the prescribed

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* See the SEC's PPI report (Ex. 6, p. 109):
"* * * the level of the minimum commission rates of the national securities exchanges is affected by the fact that brokerage commissions compensate brokers not only for execution and clearing services but for investment advice and other services customarily provided without extra charge."

minimum commission rates. The mathematical operation of the practice is illustrated in the margin.*

An exchange member acting as adviser-underwriter of a mutual fund was in no different position. He could execute the fund's portfolio transactions at the prescribed minimum commission rates; or he could receive give-ups from the executing brokers. In either case he was free to reduce the fund's advisory fee by the amount of the commissions or give-ups. The expert witnesses, Mr. Bishop and Mr. Calvin, testified that such a fee reduction was not a forbidden rebate (pp. 13-14, above), and they were clearly right; for while the fee was reduced or eliminated, the fund still paid the minimum commissions.

The same principle supported the propriety of NASD recapture on the PBW and Pacific Exchanges. The fund paid the prescribed minimum commissions to the PBW or Pacific brokers executing its portfolio transactions. The fund's adviser-underwriter, as NASD member, shared in these commissions through give-ups; and it reduced the fund's advisory fee by the amount of the give-ups. Again this fee reduction was not a forbidden rebate; for so long as the fund paid the minimum commissions, the presence

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* Suppose that, over a period of time, a customer had incurred minimum commissions of $100,000. His investment advisory fee for the same period was $120,000. If the fee was reduced by the amount of the commissions, the customer paid his broker a net amount of $120,000 ($100,000 as commissions and $20,000 as the balance of the fee). Since this was more than the minimum commissions, the anti-rebate rule was satisfied.

Or suppose that the minimum commissions were $100,000, while the advisory fee was only $80,000. If the commissions were applied against the advisory fee, the fee was eliminated; but the customer still had to pay the minimum commission of $100,000. Again the anti-rebate rule was satisfied.

or absence of any additional fee charges was of no concern to the Exchanges.* NASD recapture was thus wholly consistent with the anti-rebate rules.

2. The rulings of the PBW and Pacific Exchanges sustaining NASD recapture (pp. 11, 12, above) lend added, indeed decisive weight to this conclusion. It is elementary that the interpretation of an administrative regulation by the agency issuing it has "controlling weight unless it is plainly erroneous or inconsistent with the regulation"; *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965). The PBW and Pacific Exchanges had adopted their anti-rebate rules as part of the self-regulation authorized by §§ 6 and 19 of the Securities Exchange Act (C. 3-8); see *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 352-53 (1963). The interpretation by these Exchanges of their own rules is thus entitled to no less credit than th interpretation of any administrative regulation by the a[illegible]ncy adopting it. Since the interpretation of the PBW and Pacific anti-rebate rules by the Exchanges was, to say the least, a permissible one, the Court of Appeals rightly gave it controlling weight (B. 22-25).

Petitioners suggest that the Exchange rulings should be ignored because they were issued by the presidents of the Exchanges rather than the boards of governors (Pet. 21, 22). While it is true that only the boards of governors could issue "final and conclusive" interpretations of the Exchange rules,** the presidents were charged with the "duty

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* As the PBW and Pacific Exchange officials put it, the Exchanges had "no jurisdiction" or "control" over the advisory fee paid by the fund to its investment adviser (R. 1876-77, 4061-62).

** PBW Const. Art. III, § 21; Pacific Const. Art. XVIII, § 2 (H. 42, 43).

to enforce the provisions of the constitution and rules".* The power to enforce necessarily included the power to interpret. Petitioners themselves addressed their requests for interpretation to the presidents of the two Exchanges (R. 4019, 4050) and did not see fit to appeal the presidents' determinations to the boards of governors.

Petitioners' contention that all other regional exchanges forbade NASD recapture as an illegal rebate (Pet. 18) is not supported by the authority they cite (Fdg. 41, A. 14), and it is flatly contradicted by their own assertion that the Detroit and Boston Exchanges permit "the equivalent of NASD Recapture" (Pet. 34). In any event, each Exchange was, of course, competent to interpret only its own rules.

3. On petitioners' premise that NASD recapture was a forbidden rebate, they argue that the Exchanges could permit recapture only by filing a new rule with the SEC. Recapture was, however, wholly consistent with the anti-rebate rules, so that there was neither need nor room for a separate recapture rule.

**B. Recapture did not violate the antitrust laws.**

Neither Court below found recapture to be in conflict with the antitrust laws. Petitioners' assertion of such a conflict—which they barely adumbrated below (B. 23, n. 19)—is altogether insubstantial.

1. Petitioners would have it that NASD recapture was a " 'split-level' discriminatory price-fixing scheme", under which other investors paid the minimum commissions while investment companies paid less (Pet. 18). As previously

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* Pacific Const. Art. III, § 4(b); PBW Const. Art. VII, § 1 (H. 42, 43).

shown, however, recapture did not relieve a mutual fund from paying the minimum commissions. It reduced only the amount of the extra advisory fees which mutual funds, like other customers, voluntarily paid in addition to the minimum commissions. Those extra fees were not "price-fixed"; they were negotiated between broker and client from case to case. Competition among brokers in respect of the advisory fees was thus completely unrestrained.

What is more, the practice of reducing advisory fees in proportion to the volume of a customer's commission business was "common in the securities industry" and was often employed in favor of "nonfund clients" (PPI Report 108-9, quoted at p. 20, above). Petitioners' charge of discrimination in favor of mutual funds thus stands the truth on its head.

2. According to petitioners, the PBW and Pacific Exchanges unlawfully restricted NASD recapture to mutual funds; for under the Exchange rules only investment funds could direct give-ups to non-exchange members who were members of NASD (Pet. 18, n. 17). Petitioners omit to mention that they themselves directed substantial amounts of PBW and Pacific give-ups to NASD dealers who sold the shares of the fund (R. 1941-43). If the Exchange rules permitting such give-ups were discriminatory, as petitioners claim, it was thus petitioners who violated the antitrust laws. The violation would not have been aggravated if petitioners, instead of using the give-ups to their own advantage, had directed them to Crosby with a view to reducing the Fund's advisory fees. The Court below so held (B. 23, n. 19). Certainly petitioners, as fiduciaries, cannot claim that the give-up benefits "should be put in their own

pockets, because they were unlawful gains, for fear that the conscience of the cestui que trust should be defiled by a participation in them. To indulge trustees in such an obliquity of conscience would be holding out immunity for misconduct''; *Barney* v. *Saunders,* 57 U.S. (16 How.) 535, 543 (1853).

3. The posture of this case hardly invites review of petitioners' antitrust argument by this Court. The perpetrators of the supposed discriminatory scheme—i.e., the Stock Exchanges and their members—are not before the Court. Nor does any investor claim to have been victimized by the supposed discrimination. The issue is raised, instead, by fiduciaries who contend that they could not do their duty because they might have incurred antitrust sanctions. The Court of Appeals rejected the defense (B. 23, n. 19), and this Court should not, in the absence of the parties directly concerned, review antitrust problems presented in such oblique and hypothetical fashion.

## POINT II

### The Court of Appeals properly found petitioners guilty of gross misconduct under former § 36 of the Investment Company Act.

Section 36 of the Act, prior to its 1970 amendment, authorized the SEC to bring suit for the ouster of fund fiduciaries guilty of ''gross misconduct'' (C. 2). The Court below held, and it is now undisputed, that gross misconduct also furnished the basis for a private right of action under the Act (B. 5-6).

Petitioners argue that the Court of Appeals, in finding them guilty of gross misconduct, applied erroneous legal standards and made unwarranted findings of fact. Both contentions are unfounded.

**A. The Court of Appeals applied proper legal standards.**

Section 36 does not define "gross misconduct", but other provisions of the Act as well as its legislative history provide helpful guidance.

1. Section 1(b)(2) of the Act (F. 36-37) declares that "the national public interest and the interest of investors are adversely affected"—

> "2. When investment companies are organized, operated, managed * * * in the interest of directors, officers, investment advisers * * * rather than in the interest of all classes of such companies' security holders; * * *."

This language is amplified by a canon of statutory interpretation set forth in the concluding sentence of § 1(b):

> "It is hereby declared that the policy and purposes of this title, *in accordance with which the provisions of this title shall be interpreted,* are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors." (Emphasis added)

The policy of the Act thus requires the investment adviser and directors of an investment company to manage it solely in the interest of the company, to the exclusion of their own interests. The term "gross misconduct" in § 36 must be interpreted in accordance with this policy. A merely negli-

gent breach of duty is not gross misconduct. Petitioners, however, operated the Fund's commission give-ups in their own interest rather than in the interest of the Fund. This is the very type of misconduct which § 1(b)(2) condemns and which the Act was designed to prevent. To exclude such misconduct from the sweep of § 36 would nullify the purpose of the Act and defeat the canon of interpretation of § 1(b).

The legislative history of § 36 confirms this analysis. Section 36 is derived from § 17(e) of the bill originally proposed by the SEC (S. 3580, 76th Cong., 3rd Sess.), which provided criminal sanctions for "gross misconduct". Mr. David Schenker, counsel for the SEC, explained that this term was chosen in order to preclude criminal liability for mere negligence; *Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency,* 76th Cong., 3rd Sess., 1940, p. 262. The pursuit by fund fiduciaries, such as petitioners, of private gain at the expense of the fund thus falls squarely within § 36. *Greene, Fiduciary Standards of Conduct under the Investment Company Act of 1940,* 28 Geo. Wash. L. Rev. 266, 270, n. 12 (1959); *Eisenberg and Lehr, Directorial Responsibility under the Investment Company Act of 1940,* 20 Rutgers L. Rev. 181, 203 (1966).*

*Aldred Inv. Trust* v. *SEC,* 151 F. 2d 254, 260 (1st Cir. 1946), cert. den. 326 U.S. 795, affirmed a finding of gross

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* Petitioners' contention that the legislative history equates gross misconduct with "shocking abuse" (Pet. 25, n. 26) is a flagrant distortion. Petitioners' claimed source (*Senate Committee Hearings, supra,* p. 40) has nothing whatever to do with § 36 or its predecessor, but is a narrative statement that the SEC's investigation of investment companies had uncovered many "shocking abuses".

misconduct because the defendants had "been using their control of other people's money to enrich themselves through the perquisites of such control." This language fits precisely the present petitioners' conduct. Equally apposite is the concurring opinion (151 F. 2d at 261):

> "In view of the declaration of policy set forth in the Act in question it appears that the term 'gross abuse of trust', as used therein, covers a course of conduct by the officers and controlling stockholders of an investment company in violation of the standards of conduct generally applied to fiduciaries, such as would exist if they were acting with other than disinterested motives."

*Accord*: *Brown* v. *Bullock,* 194 F. Supp. 207, 237-245 (S.D.N.Y.), *aff'd en banc,* 294 F. 2d 415 (2d Cir. 1961).

2. In order to mitigate the danger of self-dealing on the part of fund management, § 10 of the Act (F. 37-38) requires a majority of the fund directors to be unaffiliated with, i.e., independent from the adviser-underwriter.*

Section 10 was enacted to protect fund shareholders from exploitation by insiders with conflicting interests; *National Ass'n of Securities Dealers* v. *SEC,* 420 F. 2d 83, 92 (D.C. Cir. 1969), rev'd on other grounds sub nom. *Investment Company Institute* v. *Camp,* 401 U.S. 617 (1971). The unaffiliated directors cannot perform their function as "watchdog directors" (B. 13) without full and fair information about the affairs of the Fund; and since only management

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* Forty percent of the directors must be unaffiliated with the investment adviser; a majority must be unaffiliated with the underwriter, §§ 10(a) and 10(b)(2). A director controlled by the adviser-underwriter is deemed affiliated with him; § 2(a)(3)(C) of the Act (F. 37).

can furnish that information, it is management's duty to supply it. *Imperial Financial Services, Inc.*, '64-'66 CCH Fed. Sec. L. Rep. ¶ 77,287, at p. 82,464 (SEC 1965):

> "The Investment Company Act requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company."

Indeed, the policy of the Act requires the imposition of this duty on management. Section 1(b)(1) of the Act declares that it is "contrary to the national public interest in the interest of investors" when investors are "without adequate, accurate and explicit information, fairly presented, concerning * * * the circumstances, [and] policies * * * of such [investment] companies and their management" (F. 36). The same requirement of full and fair information must apply to the unaffiliated directors, who are the eyes and ears of the investors.

Again, § 36 of the Act must be interpreted in accordance with this statutory purpose and policy. The need for action by the unaffiliated directors is particularly urgent in areas where the management of the fund is subject to conflicting interests. Management's duty to inform the unaffiliated directors becomes then imperative. To exclude a knowing violation of that duty by management from the reach of § 36 would frustrate the statutory schemes and policies.

In the present case, petitioners knew as early as 1965 and 1966 that the SEC approved and, indeed, urged NASD recapture. Petitioners had a direct selfish interest in pre-

venting recapture by the Fund. They did prevent it by withholding the SEC's views from the unaffiliated directors. Their deliberate and contemptuous disregard of the unaffiliated directors flagrantly manifested itself after the commencement of this action: Petitioners concealed from the directors the finding of their own counsel, Mr. Reilly, that NASD recapture was readily available on the PBW and Pacific Exchanges (B. 20-21); and they compounded this nondisclosure by the affirmative falsehood of telling the directors that counsel had found recapture to be impossible on all major regional exchanges (p. 16, above). As a result of petitioners' conduct, the give-up dollars which should have gone to the Fund were used for petitioners' benefit. Petitioners' conduct flouted the purposes and policies of the Act. It was nothing less than gross misconduct.

***The decision below is not in conflict with the Second Circuit's decision in* Rosenfeld v. Black.**

The Court below held it unnecessary to decide whether a breach of duty less than gross is a sufficient basis of fiduciary liability under the Act (B. 5-6). *Rosenfeld* v. *Black*, 445 F. 2d 1337, 1342-46 (2d Cir. 1971), has since answered the question in the affirmative. Petitioners are not aggrieved because they were judged by a standard more lenient than that of *Rosenfeld*.

Petitioners invoke the Second Circuit's statement that gross misconduct means "highly reprehensible conduct" (445 F. 2d at 1346), but that phrase plainly fits petitioners, who used their fiduciary powers to enrich themselves at the expense of the Fund. It is thus hardly necessary to add that the quoted phrase was mere dictum, since the *Rosenfeld*

defendants were found liable even though their misconduct was not held to be "gross".

**B. The findings of fact of the Court of Appeals were in accord with the overwhelming weight of the evidence.**

1. Contrary to petitioners' assertion (Pet. 28), the Court of Appeals was clearly aware of its limited functions as finder of facts and guided itself accordingly (B. 5, n. 6). FRCP 52(a) authorized the Court to set aside findings of the District Court which were clearly erroneous and to make opposite findings required by the great weight of the evidence.*

2. According to petitioners, the Court below overlooked that they allegedly acted in good faith and pursuant to the advice of counsel; but actually the Court considered and overruled the defense (B. 16). The flimsy nature of the defense has been discussed (pp. 16-18, above). Petitioners do not dispute that they knew the SEC's recapture views; even if counsel advised them differently, the issue was plain; it was their duty to report it to the unaffiliated directors, since it involved a head-on conflict of interests between petitioners and the Fund. Petitioners themselves do not contend that anybody advised them that it was unnecessary to inform the unaffiliated directors.

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* Thus in *U.S.* v. *U.S. Gypsum Co.*, 333 U.S. 364, 393-400 (1948), this Court overruled, as clearly erroneous, the district court's finding that the defendants had not engaged in an antitrust conspiracy and found affirmatively the existence of a conspiracy. For other instances of appellate findings opposite to those of the district court, see, e.g., *U.S.* v. *Singer Mfg. Co.*, 374 U.S. 174, 194, n. 9 (1963); *J. Gerber & Co.* v. *S. S. Sabine Howaldt*, 437 F. 2d 580, 588 (2d Cir. 1971); *Smith* v. *Sol D. Adler R. Co.*, 436 F. 2d 344, 350 (7th Cir. 1970).

3. Petitioners contend that at least Johnson 3d should be exonerated because he did not become a Fund director until April 1968. The point was not raised in the Court below. Although petitioners' brief below (pp. 90-91) devoted a separate section to the issue of "gross misconduct", the name of Johnson 3d was not once mentioned throughout the brief. He cannot now claim differential treatment since he did not seek it below.

In any event, the record fully establishes his liability. At least since 1962, and throughout the years involved in this litigation, he was a vice president of the Fund as well as FMR (R. 4077) and owned 29% of FMR's stock (R. 2905). He testified that it was his responsibility as officer of the Fund "to observe the overall operation, to see that the Fund is run—to the best of our ability—in the best interests of the Fund shareholders" (R. 2903-04). Certainly this responsibility included a duty to inform the unaffiliated directors of policy issues involving a conflict of interests between the Fund and FMR. Johnson 3d knew of the recapture views expressed by the SEC at the hearings of 1965 and 1966; he discussed them with his father, Johnson 2d; but he did not inform the unaffiliated directors (R. 2934-35, 2956-60). His misconduct, which inured to his profit as stockholder of FMR, was no less gross than that of the other petitioners.

## POINT III

### The issues raised by the petition do not warrant review by this Court.

1. Petitioners would have this Court decide whether NASD recapture violated the exchange anti-rebate rules or the antitrust laws. With the abolition of give-ups in Decem-

ber 1968, the possibility of NASD recapture has become a matter of the past. The issue thus lacks public importance, if it ever had any.

Petitioners contend that "[t]he equivalent of NASD recapture" is still available on various regional exchanges (Pet. 33-34). The assertion, if true,* would only confirm the consensus of all regional exchanges that recapture does not infringe the anti-rebate rules. So far as the antitrust laws are concerned, petitioners themselves do not maintain that the supposed "equivalent to NASD Recapture" involves discrimination in favor of mutual funds; petitioners' antitrust argument, based on discrimination, is therefore inapplicable.

2. According to petitioners, "issues similar or identical to those at bar" are raised in some fifty currently pending actions (Pet. 31). The number is highly exaggerated; many of the cases overlap (involving as they do identical fund families); some have been settled. None of them has produced a decision at variance with that of the First Circuit below. In the absence of an inter-circuit conflict, the mere pendency of cases supposedly similar to that at bar hardly affords a ground for granting the writ. See this Court's Rule 19(1)(b).

3. The petition suggests that the Court below laid down an absolute fiduciary duty of fund managements to effect

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* Petitioners speak of a "discount" available to NASD members under various regional exchange rules (Pet. 34, n. 40). Mutual funds are not members of NASD; petitioners do not explain how mutual funds can enjoy the discounts. If a method could be devised of "passing the discount on to mutual funds" (*ibid.*), it would be equally available to nonfund customers. Obviously the present case is not the place to explore the antitrust incidents of hypothetical recapture methods whose operation has not been developed by the evidence.

recapture whenever it is feasible (Pet. 12, 31-32, 34). Actually the Court below merely held that *the Fund's charter* rendered recapture mandatory (B. 7-8); the Court imposed liability because petitioners knowingly withheld the SEC's recapture views from the unaffiliated directors. Other fund cases may involve no comparable charter provision or no similarly secretive conduct on the part of management. The scope of the decision below is too narrow to invite review by this Court.

4. The finding below that petitioners were guilty of "gross misconduct" under old § 36 of the Investment Company Act can have no substantial effect as a precedent. As noted, the 1970 amendment of § 36 has eliminated the term "gross misconduct" from the statute (G. 39-41).

There is no conflict between the decision below and the Second Circuit's dictum in *Rosenfeld* v. *Black, supra* (445 F. 2d 1337, 1346), that gross misconduct must be "highly reprehensible" (pp. 30-31, above). The Court below refrained from listing synonyms for the phrase "gross misconduct"; but there can be no doubt that petitioners' conduct, in using their fiduciary powers to enrich themselves at the expense of the Fund, was "highly reprehensible".

## CONCLUSION

**The petition for a writ of certiorari should be denied.**

Dated: October 29, 1971.

Respectfully submitted,

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# APPENDIX F

## Excerpts from §§ 1(b), 2(a) and 10(a) and (b) of the Investment Company Act of 1940 prior to its 1970 amendment.

### Section 1(b)

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * * * *

*Appendix F*

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

**Section 2(a)**

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

**Section 10**

SEC. 10. (a) After one year from the effective date of this title, no registered investment company shall have a board of directors more than 60 per centum of the members

of which are persons who are investment advisers of, affiliated persons of an investment adviser of, or officers or employees of, such registered company.

(b) After one year from the effective date of this title, no registered investment company shall—

* * * * *

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or affiliated persons of any of such principal underwriters;

* * * * * *

# APPENDIX G

## Section 36 of the Investment Company Act of 1940, as amended December 14, 1970 (84 Stat. 1428).

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the

security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was

instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this title for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

# APPENDIX H

## Stock Exchange Regulations

### PACIFIC COAST STOCK EXCHANGE

#### Constitution

Article III, Section 4:

Sec. 4(b). The President shall be the principal executive officer of the Exchange, and it shall be his duty to enforce the provisions of the Constitution and Rules and to foster the general interests of the Exchange.

Article XVIII, Section 2:

Sec. 2. The Constitution shall be interpreted when necessary by the Board of Governors, which interpretation shall be final.

*Appendix H*

## PHILADELPHIA-BALTIMORE-WASHINGTON STOCK EXCHANGE

### Constitution

**Article III, Section 21:**

Sec. 21. The Board of Governors shall have power to interpret the Constitution of the Exchange and the rules adopted pursuant thereto. Any interpretation made by it shall be final and conclusive.

**Article VII, Section 1:**

Sec. 1. The President shall be the principal executive officer of the Exchange and the office shall be his principal occupation to which he shall devote his full time. He need not be a member of the Exchange. He shall have general care of the interests of the Exchange and shall be responsible for the management and administration of its affairs. It shall be his duty to uphold and enforce the Constitution and Rules of the Exchange.

# REPLY BRIEF OF THE PETITIONER

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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-319

EDWARD C. JOHNSON 2d, EDWARD C. JOHNSON 3d, FIDELITY MANAGEMENT & RESEARCH COMPANY and THE CROSBY CORPORATION

*Petitioners*

*v.*

ROSE MOSES, FIDELITY FUND, INC., C. RODGERS BURGIN, GEORGE R. HARDING and GILBERT H. HOOD, JR.

*Respondents*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## REPLY BRIEF FOR PETITIONERS

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In The

# Supreme Court of the United States

October Term, 1971

No. 71-319

EDWARD C. JOHNSON 2d, *et al.*
*Petitioners*

*v.*

ROSE MOSES, *et al.*
*Respondents*

On Petition for Writ of Certiorari to the
United States Court of Appeals
for the First Circuit

## REPLY BRIEF FOR PETITIONERS

The Respondent Moses ("Respondent") seeks to support the judgment of the Court of Appeals largely on grounds other than those on which the Court of Appeals itself decided the case. As we shall develop, this is further evidence of the weakness of the decision below and the need for this Court's review.

### I. As to the Illegality of NASD Recapture

The Court of Appeals admitted the obvious — that NASD Recapture was a "rebate." (B.24-25) However, the Court of Appeals held that since the PBW and Pacific Exchanges as a matter of practice "chose to permit it," the practice was not unlawful and Petitioners were under a duty to embrace it. (B.25) We contended that, beirg in fiat

contravention of the Exchanges' antirebate rules, NASD Recapture violated the Securities Exchange Act and could not enjoy any shelter from that Act against illegality under the Sherman Act. (PET. 18-25)

1. In a repetition of an argument made to the Court of Appeals (APPT's BR. 52-65 and REP. BR. 27-40) and quite properly ignored even by that court, Respondent now urges that NASD Recapture was not a rebate at all. (BR. OP. 19-23) The argument, baldly stated, is that there was no rebate because instead of being paid to the fund in cash, the "recaptured" commissions were simply to be credited by the fund's management company against an amount otherwise owing it by the fund — the advisory fee.

Extended discussion should hardly be necessary to refute this notion. Clearly, a rebate may be given either in cash or by offsetting accounts. A rebate was in fact paid to the fund under the NASD Recapture scheme although instead of the fund being paid in cash, it was given credit against money which it otherwise unquestionably owed, its advisory fee to the management company — an advisory fee which was here stipulated by all parties to be reasonable in amount. (R.4072) A rebate is a rebate, as both the Court of Appeals (B.24-25) and District Court (A.51) found here, whether given in cash or credit; whether given "by any method or arrangement, direct or indirect." (PBW CONST., art. XX, § 1, D.3).

To a great extent Respondent's argument proceeds from a false analogy to the New York Stock Exchange's Rule 440A. That rule permits NYSE member stockbrokers to reduce the charges they make to clients for certain advisory publications and services by the amount of commissions on their accounts. See Appendix I. The theory behind the rule is that the commission itself includes conventional

"broker's research" (F.60, A.22) and that an advisory fee paid to a broker can be reduced to the extent it is paid for such "research" so as to avoid duplication of charges. (See Br. Op. 20) In the first place, it should be noted that this practice was covered by a published rule of that Exchange.[1] Moreover, as the District Court found, Rule 440A permits brokers to reduce their advisory fees only by the value of conventional broker's literature — publications and printed services. (F.60, A.22) The Court of Appeals did not disturb this finding.

Most fundamentally, the fact that Respondent's advisory fee crediting argument, based on NYSE Rule 440A, is a red herring follows from the point that, of course, Crosby was not a stockbroker. Crosby did no brokerage business; it was not and could not be an exchange member; it neither bought nor sold portfolio securities for the Fund. (F.56-60, A.19-22) In NASD Recapture, its sole function was to serve as a conduit for the rebating of fund brokerage to the Fund. On the other hand, the brokers who actually executed the Fund's transactions on the regional exchanges did not serve

[1] There is much talk in the Brief in Opposition about "expert witnesses" "vouching for" NASD Recapture. (Br. Op. 13-14, 19, 21) What the cited passages of the record have to do with is the testimony of NYSE officials as to its practice under Rule 440A permitting brokers *who were also investment advisers* to make a reduction in their fees for statistical and investment advisory services in accordance with commissions generated. (R.4369-70, 5099-5102) This is evident even from the passages quoted at Br. Op. 14, which discuss NYSE member firms, who of course must be stockbrokers, reducing their advisory fees. The testimony had nothing to do with NASD Recapture. It must be remembered that the case was tried in the District Court not only on charges that the Fund should have engaged in NASD Recapture earlier than it did, but also on charges that it should have formed a brokerage subsidiary or affiliated itself with a stockbroker, and thus achieve "exchange recapture". The District Court rejected this latter contention (F.45-64, A.16-23, 52-53) and the Court of Appeals affirmed. (B.8-10)

as the Fund's adviser, either directly or through an affiliate.[2] NASD Recapture did not involve a stockbroker reducing its advisory fees to a client by reason of the client's commission business. Rather it was a device by which stockbrokers, who were not the Fund's investment adviser and who were owed no advisory fees, passed a share of their commissions on to a conduit, like Crosby, for rebate to the Fund.

Moreover, despite Respondent, neither the PBW nor the Pacific Exchange officials who tolerated NASD Recapture did so on the basis of Respondent's theory. Mr. Wetherill, the president of PBW, simply testified that his exchange had no jurisdiction over Crosby or what it did with the give-ups it received. (R.1881-83) That, of course, would allow Crosby to pay the cash directly back to the Fund customer; and Respondent's counsel so admitted in closing argument in the District Court. TRANSCRIPT, July 20, 1970, p. 154.[3] On Pacific, the Application for Preferred Rates of

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[2] This distinguishes the similar false analogy which Respondent somewhat gingerly introduces in the Brief in Opposition — Pacific Exchange membership. (BR. OP. 8) As we pointed out in the Petition, Pacific Exchange membership was never available to the Fidelity group and the Pacific Exchange changed its rules in 1965 to prevent any repetition of the situation in which four "direct-selling" fund groups had affiliates join that Exchange. (PET. 9 n.10)

[3] The following colloquy occurred during the closing argument:

"[RESPONDENT'S COUNSEL]: [Mr. Wetherill] said that this policy had always been the policy of the Exchange. It did not represent a new policy. The Exchange had no jurisdiction over what the NASD member did with the give-ups.

"THE COURT: You mean if the member gave it directly to the customer?

"[RESPONDENT'S COUNSEL]: Presumably that would have been permitted also because, according to Mr. Wetherill, there was no jurisdiction over what the NASD member did with the give-up money that he received."

Commission which a fund distributor had to sign in order to receive the preferred rate of commission (which Respondent claims can be passed on to the Fund) contained a solemn promise that "the applicant [i.e., Crosby] will charge customers [i.e., the Fund] . . . not less than the minimum public rates of commission as established by said Exchange. The applicant will not directly or indirectly extend or grant the Preferred Commission Rate to another not approved by the Exchange to receive such rate". (D.17) The indications that crediting was permissible were simply lawless views on the part of two exchange officials which reflect a refusal to enforce the exchanges' antirebate rules.

Respondent's entire argument that NASD Recapture was not a rebate and therefore legal accordingly fails. Respondent argues (Br. Op. 23) that since NASD Recapture was not a rebate and, hence, not inconsistent with the antirebate rules, the regional exchanges did not have to cover it with a filing with the SEC under the Exchange Act. The trouble is that no one has ever claimed, apart from Respondent, that NASD Recapture was not a rebate. The SEC staff member who threw it out as a suggestion at the 1965 meeting with Fidelity characterized it as "a rebate of commissions." (F.65, A.23) The District Court and the Court of Appeals held it was a rebate. (A.51; B.24)

2. Equally unavailing is Respondent's argument that there was no antitrust violation inherent in NASD Recapture.[4] Respondent contends (Br. Op. 23-25) that NASD Recapture did not involve a split-level commission system

[4] Respondent suggests that this case is an inappropriate one in which to determine whether NASD Recapture involved an antitrust violation. (Br. Op. 25) But it has always been undisputed in this case that if NASD Recapture was unlawful, Petitioners had no obligation either to engage in it or to tell the other directors of the Fund about it. (B.22) Since it has always been the Petitioners' position that NASD Recapture was unlawful be-

under which some customers of brokers would pay one level of commissions and others would pay a lower level, but simply involved competition among brokers who were also investment advisers, the competition being evidenced by reduced advisory fees. Since neither FMR, Crosby, nor anyone else in the FMR organization was a stockbroker, it is impossible to follow this argument. Once again, Respondent attempts to obfuscate the issues as to NASD Recapture by using some of the evidence which was adduced in her unsuccessful effort to show that the Fund should have affiliated itself with a stockbroker. NASD Recapture involved funds whose advisory organizations were *not* engaged in the brokerage business. Under NASD Recapture, only mutual funds could have achieved reduced commissions.[5] (See PET. 18 & n.17)

## II. As to the Finding of Gross Misconduct Under Section 36 of the Act

1. Respondent makes no serious effort to deny that the standard of "guilt" of "gross misconduct" laid down by the Court below (see PET. 27) was completely in conflict with

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cause, among other things, of the antitrust laws, it certainly is not "oblique" or "hypothetical" (BR. OP. 25) to pass on the issue before holding them liable.

[5] Respondent also argues in passing that if NASD Recapture violated the antitrust laws, so did the direction of give-ups by funds to unaffiliated dealers who were engaged in selling shares of the fund. (BR. OP. 24) Respondent neglects to mention the fact that give-ups, directed at the instance of mutual funds, were expressly sanctioned by filed rules of the exchanges, to the extent that they did not violate the anti-rebate rules which were also filed. (PET. 22-23 n.24) Moreover, these customer-directed give-ups to other brokers simply broadened the category of brokers who were sharing in the fund's commissions (R.4506), and did not involve a return of commissions to the funds with the consequence of a split-level discriminatory commission system.

that enunciated by the Second Circuit in *Rosenfeld* v. *Black*, 445 F.2d 1337, 1342-46 (2d Cir. 1971). However, Respondent attempts to dismiss the conflict by saying that under the *Rosenfeld* decision, Petitioners might still have been held liable — as it was held that the defendants in *Rosenfeld* could be — for civil damages other than through a finding of "guilt" of "gross misconduct" under Section 36 of the Act. (Br. Op. 30-31)

Respondent thus asserts that Petitioners are not wronged by being branded with "guilt" of "gross misconduct" under the extraordinary standard laid down by the First Circuit because some other court might still have found them pecuniarily liable without imposing that stigma on them. This hardly detracts from the necessity of this Court's review. *Cf. Cole* v. *Arkansas*, 333 U.S. 196 (1948). The damage to Petitioners' reputations through their conviction by the Court of Appeals of "guilt" of "gross misconduct" still remains. Moreover, it is sheer speculation whether the Court of Appeals for the First Circuit would have found civil liability in this case otherwise than for "guilt" of "gross misconduct" under Section 36. The District Court was of the opinion that Section 36 was the sole source of civil liability in the federal courts in the case at bar (A.45-46); the Court of Appeals did not disagree (B.5-6); liability was founded solely on a conviction of "gross misconduct."

Here again, the fact that Respondent finds it necessary to seek to uphold the Court of Appeals' judgment on a ground other than that on which it was rendered underscores the need for this Court's review.

2. In an effort to suggest that Petitioners were properly found "guilty" of "gross misconduct," Respondent not only

suppresses certain facts but also affirmatively misstates others.

(a) Respondent claims that "the SEC repeatedly and emphatically supported" NASD Recapture. (Br. Op. 7) The only authorities cited are the remarks of the SEC staff members — who neither spoke for the Commission nor explained how NASD Recapture could be squared with the antirebate rules[6] — in the 1965 and 1966 hearings, and the single sentence quoted from the PPI Report. (Br. Op. 8-10) Respondent suggests that the SEC in the PPI Report found NASD Recapture to be consistent with the antirebate rules. (Br. Op. 10) However, when one quotes (as we did, Pet. 9-10, and as Respondent did not) the preceding sentence in the PPI Report, it is plain that all that is being talked about are the give-up rules and that no consideration is being given to the antirebate rules.

Despite Respondent's implications (*e.g.*, Br. Op. 5-7), the use of customer-directed give-ups to stimulate sale of Fund shares was not a private scheme concocted by the Petitioners.[7] It was, rather, a general industry practice, openly followed, which arose from the fixed minimum commission system and the fact that the antirebate rules prohibited paying the commissions back to the funds. (R.4857-58) The Fidelity group, like the industry generally (PPI, p. 184 n.114), described the practice in annually updated prospectuses

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[6] The SEC staff member who first brought it up called NASD Recapture a "rebate." (Pet. 8)

[7] The release of January 26, 1968 (R.3740-52) simply *proposed* a rule (10b-10), a rule which would have operated only *prospectively* had it been adopted, and *it never was adopted*. The Court of Appeals condemned the Petitioners *retroactively* for not pursuing a course that no one at the time was pursuing.

(F.114, A.39-41) and in annual proxy statements (F.93, A.32-33), which were reviewed by the SEC, without challenge from that agency.[c]

This is underscored by the remarks of SEC General Counsel Loomis and his assistant Phillips, at the University of Pennsylvania Mutual Funds Conference, that fund managers, in using customer-directed give-ups to encourage sales of fund shares, were not "in any way delinquent." These remarks were made immediately following a reference to the PPI NASD Recapture suggestion. Compare p. 835 with p. 834, 115 U. Pa. L. Rev., No. 5 (March 1967),

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[c] Respondent consumes much space in attacking Petitioners for allegedly "enriching themselves" by directing give-ups of Fund brokerage to reward sales. But the substantial benefits the Petitioners obtained for the Fund at the expense of sales reciprocals belie the charges that NASD Recapture was not taken up with the Board for fear that sales might be injured. The District Court found that in obtaining best execution on Fund portfolio transactions the Fidelity group used the Third Market (where there is no fixed minimum commission schedule) *far more than any other mutual fund* thereby achieving a savings on trades in that market of approximately 40% compared to the standard stock exchange commissions. (F.21-22, A.8-9) The Fund never directed give-ups on the Third Market (R.1197, 1504; see PPI, p. 178) and leading Third Market dealers did not sell Fund shares (see R.4519, 5397). For the years 1966-1968, by their extensive use of the Third Market, the Petitioners achieved commission savings for Fidelity Fund of approximately $1,000,000 and for the Fidelity group overall of approximately $5,350,000, all at the expense of sales reciprocal. At all relevant times "exchange recapture" would have involved the loss of far more sales reciprocal than NASD Recapture (see R.3743); yet the Petitioners put the item of the Pacific memberships on the agenda for a meeting of the unaffiliated directors as early as January 27, 1966 (R.4846, 710-11). One would hardly inform the directors of this grand scale approach to "recapture" while concealing from them the NASD Recapture device which, when in full-scale operation later in 1968 produced only $18,428 in about seven months on PBW (R.823) and $22,312 in about four months on Pacific (R.842).

Ex. 1-K, att. 1. In view of these remarks, what it is "preposterous to suggest" (*cf.* Br. Op. 18) is that the single sentence in PPI represented an official SEC position that NASD Recapture was a course which mutual fund managements would be derelict in not pursuing.

Despite the Respondent's numerous references to the SEC's supposedly positive views as to NASD Recapture, the fact of the matter remains that the SEC's only definitive action with respect to NASD Recapture was to instigate the exchanges to abolish customer-directed give-ups upon which it depended. See Pet. 14.

(b) Respondent never addresses herself to the question how Petitioners could be "guilty" of "gross misconduct" in not earlier practicing NASD Recapture when, out of more than four hundred mutual funds in the country, they were the first to engage in it on the Pacific Exchange and the second on the PBW Exchange. (See Pet. 14, 26, 31) For the Court of Appeals to have found Petitioners guilty of "gross misconduct" because of an alleged tardiness when they were the pioneers among the industry is to condemn the entire industry with the same finding. Certainly this is a circumstance indicating the necessity of this Court's review.

(c) In an effort to suggest consciousness of wrong-doing by the Petitioners and thus to bring them within the established interpretation of Section 36 — not that enunciated below — Respondent's principal device is her story about the Reilly memorandum. (Br. Op. 11-12, 15-16, 30) The memorandum was prepared in March, 1968 by an attorney with Gaston Snow, counsel for the Fund, after a series of interviews with officials of the various regional exchanges; its background is discussed at Pet. 12-13. Here again, Respondent engages in selective quotation. Directly follow-

ing the sentence quoted by Respondent (Br. Op. 11-12), the memorandum concluded: "It must be emphasized that the conclusions as reported above are tentative at best. It is to be expected that before definitive decisions would be made, the Boards of Governors of the various exchanges will be consulted to determine policy and it is likely that the exchanges may delay decisions until the present confusion in the area has settled and certain patterns have emerged." (R.4005-06) Reilly next recommended the submission of "detailed letters" to each exchange, asking for rulings as to the permissibility of the techniques for recapture. He noted that: "With the exception of Philadelphia [referring to the Pro Fund letter], none of the exchanges have ever taken official positions on the issues . . . . It is probably safe to say that none of the exchanges, including Philadelphia, has thought through all the problems [e.g., the problems created by the antirebate rules]." (R.4006)

What was told the board of directors about Reilly's memorandum at its March 28, 1968 meeting was exactly the true state of the dilemma facing the Fund: namely, that while the published rules of the various exchanges all forbade NASD Recapture, it appeared that on certain of the regional exchanges officials might be willing to tolerate or wink at it. Despite Respondent's assertions (Br. Op. 16), what Sullivan (in the presence of Johnson and Loring) reported to the board, as stated in the minutes of the meeting at which the report was made, was: "that counsel had concluded that, in view of the anti-rebate provisions which are contained in the constitutions of all of these exchanges and the apparent inconsistency of the effect of certain rules and their interpretation with such anti-rebate provisions, answers to comprehensive written presentations made to each exchange would be necessary before any definite advice by counsel could be given." Minutes of March 28, 1968

MEETING, R.3385. This was a fair summary of counsel's position as set forth in the Reilly memorandum (R.3976-4008) and particularly in its conclusions (R.4005-08). (F.99, A.34-35) Respondent's charges of "downright misrepresentations," "deliberate and contemptuous disregard of the unaffiliated directors," and "affirmative falsehood" (BR. OP. 16, 30) are false and reckless.[9]

### III. THE IMPORTANCE OF THE QUESTIONS

In our petition, we listed, with citations to the pertinent paragraphs of the complaints, a total of 57 cases pending in the federal courts raising issues similar or identical to those at bar. (PET. 31, E.1 to E.7) Respondent states: "The number is highly exaggerated." (BR. OP. 33) Strangely, no details as to the exaggeration are given. Respondent does not deny the authenticity of her counsel's reported statement, quoted in the petition, "that there are about 50 other suits swinging on this give-up decision." (PET. 31)

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[9] Respondent, dealing with the embarrassing point that Johnson 3d was a bystander in the events as to which he was held "guilty" of "gross misconduct," claims that we cannot urge this point because "the name of Johnson 3d was not once mentioned throughout the brief" below of the Petitioners. (BR. OP. 32) Since he had been found blameless by the District Court (A.46), and had been referred to by the appellant in her brief only to identify him (APPT'S BR. 4), there was nothing for the appellee to reply to and no occasion to mention him. The reason for this general lack of mention of Johnson 3d below was that he had nothing to do with the matters charged in the complaint. The failure to mention him hardly seems a reason to find him guilty. Respondent claims that Johnson 3d was shown by the record to have known of "the recapture views expressed by the SEC [*sic*] at the hearings of 1965 and 1966" and to have discussed them with his father. (BR. OP. 32) However, the record references cited make it plain that what Johnson 3d discussed with his father was possible "exchange recapture." He was not shown to have any specific knowledge about NASD Recapture.

Respondent also claims that some of the 57 suits "have been settled." Again we are not provided with any supporting details for this assertion. The only suit on the list of 57 as to which we are aware of a settlement is case number B-9 listed on page E-4 of the petition, *Gross* v. *Moses*, where a settlement was approved after the petition was filed.[10] That leaves 56 cases. Respondent also says that somehow the number of cases is exaggerated because of a so-called "overlap" since some of them involve "identical fund families." Whatever Respondent means, the fact remains that (disregarding the *Gross* case which has been settled) the cases which we listed in our petition involve funds accounting, as of December 31, 1970, for net assets of more than $22 billion, according to the 1971 edition of Wiesenberger on Investment Companies. It is hard to deny the importance of cases involving close to half of the entire investment company industry.[11]

Respondent also dwells on the fact that Section 36 of the Act was amended in 1970 to eliminate the term "gross misconduct." (Br. Op. 34) But as we set forth in the petition (Pet. 31-33), the pending cases involve conduct before the amendment to the Act and, accordingly, must be judged under the terms of Section 36 as it stood at the time. Moreover, as we also pointed out (Pet. 32 n.36), a decision as to

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[10] We referred to the proposed settlement of *Gross* in our Petition. See Pet. 34.

[11] As of the same date, the total assets of the industry amounted to approximately $54 billion. Investment Companies 13 (Arthur Wiesenberger Services ed. 1971). However, approximately $9 billion of the industry's assets were accounted for by the four fund complexes which achieved Pacific Exchange membership. NASD Recapture is not relevant to these four complexes (p. 4 n.2, *supra*) and they are not involved in the pending litigation.

the meaning of pre-amendment Section 36 would furnish guidelines for the interpretation of the revised Section 36(a) of the Act.

In a final argument bordering on the absurd, Respondent (notwithstanding the public assertion of her counsel which we reported in the petition (PET. 31)) now claims that this case is unique since, it is said, it turns on a peculiarity in Fidelity Fund's charter. (BR. OP. 33-34; see also BR. OP. 4) That is the provision of the charter that the Fund was not to issue its stock for less than its net asset value. (R.5452) The implicit suggestion that the other mutual funds in the country are free to engage in selling their stock for less than net asset value is ludicrous. It is a fundamental fact of the industry that all mutual fund shares are sold at no less than net asset value, net of any applicable sales charges. See PPI, pp. 51, 204. The prospectuses of all mutual funds so state (see, *e.g.*, R.3685, 3588, 3618, 4780, 2737, 4616); and the Investment Company Act ordains that sales of fund shares must be made at the price set forth in the prospectus. See § 22(d) of the Act, 15 U.S.C. § 80a-22(d); see also Rule 22c-1 under the Act, 17 C.F.R. § 270.22c-1 ("net asset value"). If Fidelity Fund were obligated somehow to engage in NASD Recapture in order to obtain "net asset value" for its shares, then all other mutual funds were so obligated. It is, accordingly, idle to deny, as does Respondent, that the court below "laid down an absolute fiduciary duty of fund managements to effect [NASD] recapture." (BR. OP. 33-34) The SEC has not interpreted the decision below as simply applicable to those funds which have language similar to Fidelity Fund's language in their charters. See SEC Memorandum in Opposition to Proposed Settlement of *Gross* v. *Moses*, 67 Civ. 4186, S.D.N.Y., pp. 9-11 (August 1971). Neither did Respondent's counsel

when he admitted that some 50 pending cases in the courts all "swing" on the decision below.

With over 50 cases in the lower federal courts dependent upon this case, our petition hardly is an invitation to an "excursion into legal history." (Br. Op. 1) Moreover, as we pointed out in the petition, and as appears to be undenied, the equivalent of NASD Recapture is still available on a number of regional exchanges.[12] (Pet. 33-34) A decision in this case will thus be of crucial importance to the mutual fund industry even apart from its impact on pending litigation.

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[12] As to our statement that the availability of "discounts" to NASD members which exist under certain present regional exchange rules could result in a rebate to mutual funds, Respondent says: "Mutual funds are not members of NASD; petitioners do not explain how mutual funds can enjoy the discounts." (Br. Op. 33 n.) Let us hasten to explain. They would enjoy them the same way that Respondent contends the funds should have enjoyed NASD Recapture: by the fund's distributor, which is a member of the NASD, passing the discount on to the fund.

## CONCLUSION

For the reasons stated in the petition and in this reply brief, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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November, 1971

## APPENDIX I

### NYSE Rule 440A

### CCH NYSE Guide, ¶ 2440A

.10 *To whom furnished.* — A member or member organization may furnish:

(1) To a professional non-member (i.e., broker-dealer in securities or commodities, insurance company, investment advisor, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), statistical and investment advisory services:

(A) Prepared by the member or member organization; or

(B) prepared by others and reissued by the member or member organization in his or its own name with the consent of the original issuer or publisher, provided the reissuing member or member organization is not required to pay for such consent.

*(Exception: This policy does not prohibit the furnishing by a member or member organization to a non-member professional (i.e., broker-dealer in securities or commodities, insurance company, investment adviser, investment manager, bank, trust company, foundation, professional trustee, or one engaged in any closely allied activity), of publications of nominal cost, i.e., aggregating not more than approximately $30 per year, per non-member professional.)*

(2) To another member or member organization or to a non-member customer who is a non-professional, statistical or investment advisory services

(A) prepared by the member or member organization, or

(B) prepared by others and reissued by the member or member organization.

The meaning of "statistical and investment advisory services" above is restricted to publications or services intended to aid professional or non-professional clients of member organizations in investment decisions concerning securities or commodities. All such publications or services must be clearly and prominently identified as being a publication or service of the original issuing member organization. (The name of the original issuing member organization may be omitted if the distributing member organization clears its listed business through the issuing member organization.)

.11 *Fees.*—Such service which is prepared or reissued by the member or member organization consistent with .10 above, may be furnished by the member or member organization to another member or member organization or to a non-member, either free of cost or on a fee basis. If such service is furnished on a fee basis, the fee may be adjusted in accordance with commission business received from the other member or member organization or from the non-member.

The fee for investment advisory service may be based on a percentage of the principal amount of the funds involved but may not be based upon the profits realized.

Different fees may be charged to different customers for the same or equivalent statistical service.

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